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MACROECONOMIC POLICY QUESTIONS: FINANCING OF DEVELOPMENT, INCLUDING NET TRANSFER OF RESOURCES BETWEEN DEVELOPING AND DEVELOPED COUNTRIES

Global financial integration: challenges and opportunities

Report of the Secretary-General

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I. INTRODUCTION

1. As technological advances reduced the cost and increased the speed of international financial transactions and as policy liberalization removed barriers to international capital flows, financial institutions have increasingly added foreign assets to their portfolios. At first, mainly the short-term assets and borrowings of banks were traded internationally, but now a broader range of financial instruments is commonly found in institutional and increasingly in individual portfolios. This international diversification has also stimulated a rapid pace of innovation in financial instruments, known as derivatives, which allow financial investors to modify the types and degree of risk they face from possible changes in exchange rates and interest rates. Reflecting the extent to which these trends have come, it is now common to refer to them collectively as global financial integration.

2. Some developing countries have been able to take advantage of this globalization of finance and tap the markets for an increasing volume and variety of financial flows. 1/ But many of these countries have also been stung by the potential volatility of some of the flows. Information about financial opportunities in foreign countries is increasingly available and acted upon. Sometimes the markets move very quickly in response to new information about a market, or even rumour. Prices of financial assets, bonds as well as stocks, can undergo sharp and sudden changes and investors can decide to remove large amounts of funds from a market on short notice, causing severe pressure on local foreign exchange markets. Changes in exchange rates, especially those of the world's major currencies, are today determined more by international financial flows than by trade in goods and services. In short, global financial integration presents challenges as well as opportunities, a point recognized at the political level with the adoption by consensus of General Assembly resolution 50/91 of 20 December 1995.

3. In fact, international financial markets went through a highly unsettled period in 1994 and 1995. Many analysts had feared, for example, that a prime reason for the heavy flow of finance to Latin America in the early 1990s was the relatively low interest rates in the United States of America, which would not and did not last. Developed countries were also vulnerable. The foreign exchange markets of the major currency countries went through a very turbulent period from 1994 until early 1995, as the United States dollar plunged against the deutsche mark and the yen, several European currencies slumped against the deutsche mark, and the latter hit a record low against the yen. In addition, investors pulled funds out of Mexico in 1994 and other countries in early 1995, although funds began to return after a period of months. Moreover, it became known that certain individuals who traded in international securities, foreign exchange and commodities for large institutions had accumulated large losses and had hidden them from their top management and from market supervisors for long periods.

4. Governments and market participants clearly recognize both the benefits of the growth of international financial flows and the need to avert the adverse effects of their turbulence. Global financial integration has therefore been accompanied by the refinement in the nature of the measures taken by these

parties, individually and collectively, to enhance the environment for international capital flows. The present report reviews these aspects of efforts to strengthen international financial markets.

5. The report was prepared in cooperation with the International Monetary Fund (IMF), the World Bank and the United Nations Conference on Trade and Development (UNCTAD). The views expressed herein, however, are those of the United Nations Secretariat and not necessarily of other institutions.

II. THE GLOBAL MACROECONOMIC ENVIRONMENT

6. The international interest rates and exchange rates that are major factors in international financial flows are also central policy tools and macroeconomic indicators in the major developed economies. The evolution of the interest rates and exchange rates of these countries not only bears on the financial markets, but also on domestic decisions on spending and saving, on producing or importing - in short, on the evolution of the "real" economy. The major developed economies have thus long sought individually and collectively to reduce the uncertainty about the future course of these variables and adopt policy mixes that would promote long-run economic growth.

7. Views on how this might best be done have changed over the years, the current consensus view being that there are severe limits on the capacity of Governments to manage short-term macroeconomic developments. 2/ Instead, Governments now generally take a medium-term perspective, seeking through fiscal consolidation and steady and persisting monetary control to establish and maintain a stable and predictable macroeconomic environment. This is seen as the most effective route to build financial market confidence, stabilize expectations about inflation and economic growth and reduce financial market volatility.

8. Since this is the common view at the national level, it naturally carries over to the international level. Certainly, few policy makers would propose today another initiative of the kind embodied in the coordinated macroeconomic stimulus of 1978, which had been agreed in a summit meeting of the seven major industrialized countries (G-7). 3/ Instead, macroeconomic policy commitments at G-7 summits have become more in the nature of statements of mutual support for strong national economic policy stances in a medium-term framework. 4/

9. This notwithstanding, financial markets closely monitor what policy makers say and do, especially with respect to the cluster of key exchange rates and short-term interest rates. The markets act on arbitrage opportunities and often speculate on possible monetary policy changes that would move interest and exchange rates in particular directions. Indeed, on various occasions, financial markets have pushed exchange rates to levels that are inconsistent with medium-term equilibrium (defined in terms of trade flows and sustainable current account deficits) and have held them there. When this is judged to have happened, it becomes the role of macroeconomic policy makers in the key currency countries to jointly deflate the speculative bubble and move back towards equilibrium.

10. The most recent case in point was the coordinated adjustment process set in motion in April 1995 by the G-7 finance ministers to correct what had by then become an unsustainable - yet persisting - set of exchange rates. 5/ The process began with a clearly worded statement calling for the "orderly reversal" of yen, deutsche mark and dollar exchange rates. This came after the finance ministers had decided to issue fewer routine communiqués and instead speak only when they wanted to send a message to the market. The statement was followed by monetary policy changes in Germany and Japan and a series of exchange-market interventions, all of which together moved the exchange rates towards more "reasonable" values.

11. The nexus of this coordination exercise was like most in that it involved the dollar, the yen and a cluster of European currencies, focused on the deutsche mark. As the markets move very quickly, the central banks that would be involved in such exercises have to be in almost continuous contact. In fact, operational representatives of the main European central banks hold three telephone conference calls daily. They are joined by the Bank of Japan at their morning call and by the Federal Reserve Bank of New York at their afternoon call. When the time for concerted action on these currencies arrives, it is most likely to be decided mainly by policy makers within these circles.

12. Central bankers and finance ministers of the concerned countries also meet periodically. Central bankers from a larger cluster, the Group of 10, meet eight times a year under the auspices of the Bank for International Settlements (of which they are all members) in Basel. 6/ There the governors and presidents of the most powerful central banks discuss major issues affecting global markets and debate what their policies ought to be. Central bankers and finance ministers of the G-7 countries also meet three times a year to review economic and financial conditions at home and abroad. The G-7 finance ministers meet an additional time without their central bank counterparts at the time of the annual G-7 summits and their deputies meet 8 to 10 times a year.

13. IMF also closely monitors exchange rate matters, including those in the G-7 countries, and associated macroeconomic policies. Indeed, this is a central responsibility of the Fund under its Articles of Agreement. 7/ Moreover, the Managing Director of IMF takes part in certain G-7 discussions, where he focuses attention on the international repercussions of G-7 policies. The IMF role in the G-7 was recently bolstered, in addition, when the June 1996 G-7 summit endorsed the proposal of the finance ministers to invite the Managing Director of IMF to make presentations to them about potential risks outside the G-7 that could affect the international monetary and financial system. 8/ Provision has also been made to strengthen cooperation with Fund staff when the G-7 deputies prepare the ministerial meetings.

14. The Fund describes its role in the G-7, however, as one of "policy cooperation (i.e., information exchange, discussion and persuasion)" rather than as "policy coordination". 9/ In essence, when the Executive Board comes to a view on certain exchange-rate misalignments, it is agreed that these views "should be heard in the forums where such decisions were taken". More generally, the Fund has been asked to "identify cases of serious exchange rate misalignments and convey this information to the country authorities concerned in a timely and confidential manner". 10/

15. When IMF forms opinions on exchange rates and associated macroeconomic policies, it is within a context that embodies an assessment of the existing and prospective economic situation of the involved countries and of the world economy. At least implicitly, the same may be said for the financial market actors. Indeed, myriad macroeconomic analyses of the current situation and forecasts are prepared in the private sector, in Governments and central banks and in international organizations. There is generally a range of views on the situation of any one country, let alone in the world as a whole. Few are the forums, however, in which different views may be brought together and compared.

16. The United Nations provides one opportunity for a comparison of outlooks in its capacity as a headquarters of Project LINK. LINK serves as a forum for discussion by technical specialists of the economic situation in different parts of the world, but LINK also is a system in which forecasts based on the econometric models of individual national economies are adjusted so as to form a consistent global picture. The LINK system is a tool available to the international community to bolster the capacity to analyse the short-term developments of the global economy and its largest national components. Indeed, the annual spring meeting of Project LINK at United Nations Headquarters provides the basis on which the United Nations Secretariat prepares its global economic forecast, which it publishes in the annual World Economic and Social Survey.

III. MAKING INTERNATIONAL FINANCIAL MARKETS WORK BETTER AND SAFER

17. Capital controls in the developed countries are a thing of the past. One consequence is that the prudential and market monitoring responsibilities of central banks and securities oversight agencies in individual countries have increasingly had to take on an international dimension. The national institutions still must supervise bank operations, securities issuance and trading activity, set standards for disclosure of financial information and otherwise exercise surveillance. But they must now pay keen attention because what happens in one market soon finds a reflection in another. This "fact of life" has made international cooperation an increasingly important aspect of official measures to reduce systemic risks in the financial sector.

18. International cooperation in these areas emerged in an ad hoc way, as various specialized international institutions took the initiative in different segments of international financial activities. 11/ Most senior among them - having been established in 1930 - is the Bank for International Settlements in Basel. As the Bank is owned by 32 national central banks, its focus has traditionally been on commercial banking and monetary activities, although it is necessarily taking an ever broader financial focus.

19. Another forum for international cooperation is the International Organization of Securities Commissions (IOSCO), founded only in 1983, which oversees stock exchange activities. IOSCO has both official and private members, as some stock exchanges are self-regulating. The International Association of Insurance Supervisors (IAIS) is an international forum that has taken on additional importance in international financial circles, as

restrictions are relaxed on international investment by insurance companies, pension funds and other institutional investors.

20. Both IOSCO and IAIS have been developing closer ties with the Basel Committee, a banking forum whose role will be discussed in the following section. This cooperation is being strengthened not only because different types of financial institutions trade the same financial instruments, but also because of the emergence of national and international financial conglomerates. Some formalization of responsibility for the consolidated supervision of corporate groups that offer a comprehensive range of financial services has been increasingly discussed. National authorities remain divided, however, as to the merits of the centralization of supervisory responsibilities, although there is a consensus on the need for further cooperation nationally and internationally. Indeed, it has been occurring. 12/

21. While many market-strengthening activities are engendered through these and other official international organizations, international private groups have also taken increasingly prominent roles, ranging from professional associations (as in accounting) to industry groups (such as the Institute of International Finance, which is an association of private financial institutions that, inter alia, engages in informal dialogues with regulatory bodies). In addition, sometimes market participants directly act together on an ad hoc basis.

22. One example of the latter responds to the concern, arising from the ever-exploding number of international financial transactions, that the payments mechanisms might not be able to settle all transactions on a timely basis. It has also been feared that because of the complex network of inter-bank payments, the sudden failure of one bank could quickly spread through the network and bring down other banks. This is known as concern about "settlement risk", i.e., the risk that an institution would pay the funds it owes on a transaction and not receive the funds due to it from its counterparty (as in foreign exchange trading). The solution is to reduce the required number of transactions through schemes ranging from bilateral netting agreements to establishing a multi-bank clearing house (all participating banks pay the clearing house instead of one another and settle only the net balances). 13/

23. Financial market developments, in general, are also reviewed in the Organisation for Economic Cooperation and Development (OECD), while liberalization of conditions for international access to national financial markets is likely to be decided in the World Trade Organization. IMF, however, provides the one regular and detailed intergovernmental overview from a perspective of global economic and financial stability. These reviews also feed into United Nations discussions of global financial conditions, reform of the international monetary system and improving the access to international finance of developing and transition economies.

A. Advances in official oversight of international financial markets 14/

24. International initiatives to improve the prudential supervision of banks with cross-border operations date from the 1970s. They were a response to the awareness of regulatory authorities in countries with large financial centres that a major banking default could have a destabilizing effect that would extend beyond the jurisdiction in which it took place. The main forum for these initiatives has been the Basel Committee on Banking Supervision, formed in 1974 at the Bank for International Settlements. 15/

25. The application of Basel Committee agreements, however, is not limited to members of the Committee and the Bank. Standards promulgated by the Committee are accepted in many other countries. This process will likely be reinforced by the insistence of many countries during the negotiations on financial services in the World Trade Organization that observance of the Basel standards by regulators in the banks' home countries should be among the conditions for the granting of market access.

26. The early work of the Basel Committee focused on strengthening the standards of prudential supervision of international banks and improving international supervisory cooperation, while fostering better internal control by banks of their international credit risks and developing internationally uniform standards for the capital required to be held against credit risks. The latter was intended both to raise prudential standards and to "level the playing field" for international competition among banks. Thus, in July 1988 the Basel Committee proposed a capital adequacy standard and provided guidelines on which assets could be counted as capital. The standard (the Basel Capital Accord) came into effect fully at the end of 1992.

27. More recently, the Basel Committee's attention has turned to capital requirements for "market risks", namely risks arising from possible changes in the prices of different financial assets held by banks. The focus of the 1988 Accord had been on "credit risk" (probability of non-payment of debt servicing) and this came to be seen to be too narrow a focus as banks not only make loans and take deposits, but increasingly also buy and sell financial securities, including derivatives, many of which are held for short periods. 16/ Now, interest rate changes and exchange rate changes in any number of markets could change the value of a significant part of the financial assets held by a bank and thus adversely affect its soundness.

28. The market-risk issue is complicated because the risk characteristics of any loan that a bank makes or security that it buys can be altered by the purchase of an options contract or another derivative (e.g., a currency or interest rate swap to change the contracted stream of payments into something deemed less risky or more profitable). Even if the risk of an individual bank loan is reduced by purchase of such a hedge, some risk remains and should be measurable. Considering the entire portfolio of loans and securities handled by a large bank and its rapid turnover, the net market risk of the bank could be quite complicated to track. Indeed, because bank managers need to monitor their net risk exposure, some institutions have developed elaborate risk measurement systems that allow a highly refined assessment of all exposure at once,

including government bonds, money market instruments, currencies, and of course, derivatives.

29. In December 1995, in response to such concerns and after three years of consultations, the Basel Committee announced a major amendment to the Basel Capital Accord. The objective of the amendment is to set new capital adequacy requirements (after a two-year implementation period), which would include not only credit risks but also the market risks arising from banks' trading activities and from their open positions in foreign exchange and commodities markets. Under specified conditions, the new Basel amendment will allow banks to use their own internal models as a basis for calculating their market risk - and thus the amount of capital backing required - albeit with risk defined in a common way, called "value at risk". 17/

30. This represents a significant innovation in supervisory methods, as increased reliance will be made on what were initially market-led initiatives for helping financial institutions manage their risk. The Committee has thus decided that in a complex and rapidly evolving financial environment, uniform quantitative rules and mechanical monitoring of balance-sheet and off-balance-sheet data are not adequate to protect against actual or potential risks. Instead, the Basel Committee is assigning greater responsibility to the senior management of financial institutions. In addition, for the banks whose internal models are judged acceptable, there will be no additional data calculation and reporting burden.

B. New thinking about regulation: making imprudence costly

31. Permitting the use of internal models illustrates a more general recent trend in thinking, which is that market discipline - in a word, the threat of bankruptcy - should work more effectively to motivate prudence in financial institutions. It should not only be the official supervisor who pushes for prudence. The ultimate key to financial stability lies within the institutions themselves, as financial activity is not only about the taking of risks, but also about the proper pricing and management of those risks. With financial innovation comes increased need for each financial institution to engage in prudent risk management practices. No financial institution should be engaging in activities its senior management does not adequately understand and its board of directors cannot oversee. Indeed, recent problem cases suggest that in most instances there were important shortcomings in internal controls and management supervision.

32. Market discipline will only be effective, however, if market participants realize that incautious behaviour and excessive risk-taking on their part will not necessarily be made good with public money. Reducing incentives to excessive risk-taking critically depends on the credibility of the authorities' commitment to limiting intervention to the necessary minimum in the event of turmoil. Each financial institution needs to believe, in other words, that it is not "too big to fail", a lesson recently learned the hard way, for example, by Barings, one of the oldest British finance houses.

33. The credibility of this threat relies as well on the perception that although individual institutions might fail, the financial sector as a whole was not fragile. In this regard, it is significant that the general perception of the vulnerability of the international banking system that emerged after the Mexican debt crisis erupted in 1982 did not re-emerge after the 1994-1995 Mexican crisis, although "a few large institutions (not necessarily banks) did face severe difficulties because of their exposure in emerging country debt". 18/

34. Besides the credible threat that imprudent behaviour will be costly, a prime requirement for more effective market discipline is greater public availability of information, in particular on the current risk exposure of financial institutions. Several initiatives have been undertaken in this regard, including a joint survey in 1995 by the Basel Committee and IOSCO of derivatives trading by banks and securities firms, detailing the degree to which disclosure of risk exposure had increased and recommending further improvements.

35. Sharing of information among major exchanges themselves about individual traders is an additional tool to limit imprudent behaviour. Following the collapse of Barings in February 1995, such efforts have been significantly strengthened. One result is that in March 1996 a comprehensive agreement was reached between major futures exchanges and supervisory authorities to share information about common members whose exposures were deemed to be either actually or potentially excessive.

36. Safeguarding the integrity of the international financial system in our highly integrated world economy has to remain a priority concern of policy makers. It requires the active participation of supervisors and supervised in an ongoing process of dialogue, accountability and cooperation, and a balancing of risks with rewards.

IV. QUALITY AND QUANTITY OF ACCESS TO INTERNATIONAL FINANCE

37. Even if the international financial markets run smoothly and safely, access to them is only open to some borrowers from some countries under some circumstances. Also, access of a country on attractive terms for a wide range of projects at one moment of time may be followed by access on less desirable terms for a narrow set of opportunities at another. The challenge for developing and transition economies is to capture the opportunities that international financial markets offer without becoming vulnerable to their volatility. The challenge for the international community is to reduce the risks and volatility of financial flows to the "emerging markets", while helping to broaden the number of countries that are viewed as in the emerging-markets category. Both of these challenges have been prominent in international policy discussion at technical and political levels since the earliest days of the "North-South dialogue".

A. Policy at the country level

38. The discussion of policy measures to enhance access to private sources of international finance begins at the country level. The key question to ask, however, is not whether foreign private financing can be attracted, but whether it will help raise the rate of capital formation. Some countries have attracted very large inflows of foreign private finance without strengthening domestic investment. Typically, these were situations of high local rates of inflation and major unresolved policy conflicts, with monetary policy seeking to contain strong inflationary pressures, leading to very high real interest rates, which made the foreign finance very costly to the country (and to the Government itself when the borrowing financed its deficits).

39. Governments are likely to find, in fact, that policies that effectively promote domestic capital formation also promote inflows of the kinds of finance that can have the largest developmental pay-offs. There are several dimensions to the policies that are most effective in this regard. 19/ The first has to do with the degree to which the future is seen to be unpredictable to potential investors. Significant private investment was not observed in the early periods in post-conflict situations owing to the political uncertainties or in the early years in the transition economies as a result of the profound institutional changes in the move from planning to market or in the heavily indebted developing countries when their debts had grown beyond what they could possibly fully service in the long run.

40. By the same token, a stable macroeconomic environment - with a low and predictable rate of inflation, a competitive exchange rate and a well-managed public deficit - greatly facilitates investment, domestic and foreign. But there is an important additional aspect of the macroeconomic situation: it should be seen to be sustainable. If macroeconomic stability is attained at the cost of high unemployment, great social strain and little economic growth, investors will understandably ask whether the next Government would reverse the policy.

41. If the possibility of policy reversal - whether macroeconomic or institutional - is seen to be high, investors will commit only to projects that have quick returns and are themselves easily reversed. In the earlier stages of programmes of macroeconomic adjustment, economic transition and post-conflict peace building, this is readily observed. But it is desirable that investors soon move to projects that entail longer-term commitments.

42. It has also become apparent that macroeconomic and political stability alone are not sufficient to stimulate private investment. Rather, improvement of the profitability of investment, access to investment opportunities and financing are important factors in investment growth. These conditions are the intended result of "structural" reforms (e.g., liberalization of trade, reduction of licensing, widening of the tax base, banking reforms), but there is no single, uniform standard for the pace, scope and sequencing of reforms. What is important is that stabilization policies and liberalization and reform measures are complementary, with consistent objectives. 20/ Moreover, they also often need complementary government expenditures.

43. Indeed, the composition as well as the size of government expenditures are important targets in fiscal adjustment. In particular, additional public investment, especially when focused on infrastructure and human resources development, can increase the profitability of private investment; but diminished public investment, where it is absorbed by a largely ineffective and non-competitive state-enterprise sector, can free resources for more productive uses.

44. In addition, the deregulation of private investment, the demonopolization of industries and privatization of state enterprises have been successful in promoting investment in a large number of countries. This has ranged from the growth of small domestic investors in labour-intensive industries, to the inflow of foreign direct investment (FDI) in export-oriented, labour-intensive industries and in capital-intensive infrastructure and mining industries. The liberalization of FDI regulations, removing disincentives in terms of ownership, taxation, repatriation of profits, exchange rate controls and access to domestic markets, reinforces the incentives (but does not substitute for them). In addition, with growing regional economic integration in Central and Eastern Europe, the Americas, Asia and Africa, foreign investors in countries in these regions can gain access to more than just the local markets.

The question of capital-account liberalization

45. While the broad thrust of policy is thus towards liberalization of markets, removal of one set of controls, those on international financial flows, has been especially controversial. The developed economies liberalized their international financial flows as generally the last step in the decontrol of foreign exchange markets. IMF itself requires only liberalization of current account transactions as part of the general obligations of Fund membership (article VIII of the Articles of Agreement of IMF). The Executive Board of IMF, however, recently considered whether to take a more active role in promoting capital-account liberalization, as a result of which it agreed to focus more on capital-account issues in its regular surveillance activities. 21/ There is, in other words, a broad range of opinion on the appropriate speed and sequencing of capital-account liberalization, including the view that in some cases it might have been or would be premature or inconsistent with other policies.

46. The concern may be illustrated by an example. If monetary policy tightening is used to fight raging inflation, domestic interest rates will be quite high. If the country is also committed to a fixed exchange rate and if financial flows are unrestricted, then the interest that a foreign investor can receive on a short-term credit in the country (e.g., purchase of a government treasury bill or a bank deposit) is likely to be much higher than in the developed country markets. If the commitment to the fixed exchange rate is credible, the incentive will exist for large-scale capital inflows and heavy demand for the local currency. To keep the exchange rate from appreciating, the central bank has to buy the excess foreign exchange, which puts more local currency into circulation. While this adds to official foreign exchange reserves, the extra domestic money in circulation lowers interest rates, raises inflation and works against the initial policy thrust. The Government can tighten policy again to offset (sterilize) this effect, but the point is that

the open financial market compromised the Government's ability to carry out its adjustment policy.

47. If the capital inflows are large enough, it would be difficult to prevent the exchange rate from rising or to sterilize all the inflows. An appreciated real exchange rate will make it harder for import-competing firms and exporters to sell their products and, if maintained for a time, will misdirect investment away from tradables to the non-tradable sector. Moreover, the foreign inflows are likely to go into the banking system as short-term deposits on which the banks must pay interest. The banks will then be under strong pressure to quickly lend out the funds and, experience suggests, not necessarily with adequate assessment of the riskiness of their clients. The loans will also likely be of a longer maturity than the new deposits, exposing the banks to potential liquidity problems. Meanwhile, capital formation is discouraged by high interest rates, high inflation and the growing realization that the process is unstable.

48. At some point, the financial inflow usually stops, devaluation pressures emerge and a balance-of-payments crisis ensues, as well as a banking crisis if the deposited funds are suddenly withdrawn from the banks. This example, a composite of the experience of several countries, is in marked contrast to that of certain other countries that, when faced with short-term capital inflows, treated them as a transitory phenomenon and a potentially disruptive one. They used a variety of policies to discourage or slow the inflow and thereby remained less vulnerable to the inevitable change in sentiment. 22/

B. Policy at the international level

49. While domestic policies of developing and transition economies are the basic determinants of the volume and structure of private capital inflows, international policies can play an important role in reinforcing their effectiveness. A major case in point is the international debt strategy that has helped a number of over-indebted developing and transition economies by alleviating the burden of debt owed to commercial bank creditors and debt owed to government creditors. As discussed in another report of the Secretary-General (A/51/294), the debt strategy continues to evolve in order to bring much more substantial benefits to a larger number of countries. In addition, the international community seeks to assist developing countries to gain or enhance access to private financial markets through a variety of guarantee programmes, co-financing arrangements and insurance programmes. 23/ More generally, the regular lending programmes of the multilateral institutions and the operational activities of the United Nations system serve to assist in adjustment periods and bolster the development capacity of the developing and transition economies. Certain new initiatives at IMF, moreover, seek to enhance the confidence of the financial markets in placing increasing funds in "emerging markets".

1. Confidence building through enhanced surveillance

50. The 1994-1995 Mexican crisis seemed to shock the official international community as much as the financial markets. With hindsight, it was clear that the Mexican imbalances had accumulated for too long a period, requiring an enormous international financial mobilization plus an extremely sharp Mexican economic contraction to restore financial market confidence (which they did). One question was thus, could the international community influence Governments more effectively to adjust imbalances before they grew to the proportions of the Mexican case? If the financial markets were more assured that imbalances would be addressed on a more timely basis, it would build confidence and enhance the inflows of more desirable types of finance.

51. The international policy response to this question began to unfold at the spring 1995 meeting of the IMF Interim Committee, where a two-pronged strategy emerged. The first prong would be to enhance IMF surveillance of the economic policies of member countries and the second would be to increase the transparency of national policies through more timely provision of improved data. Under the first prong, IMF consultations would become more frequent and IMF discussions and reports more candid. Countries that did not have active Fund-supported adjustment programmes had generally received Fund missions only for "article IV" consultations on an annual basis. Interim staff visits would now be added in certain cases. By September 1995, the Managing Director of IMF reported that 30 countries had received special messages or visits from him or his three deputies to "press points of concern raised in our surveillance". 24/ In addition, the Fund announced it would encourage Governments to provide it with more timely and reliable data, while at the same time saying it would make greater use of financial market data about member countries.

52. The Fund's request for the provision of more data for surveillance, it seemed, was a prod for the second prong of the strategy, the public provision of better data by Governments. Two data standards were to be formulated, a general one and a more demanding set of indicators for countries that had or sought access to international capital markets. By April 1996, the special data standards were adopted and completion of work on the general standards was targeted for the end of the year.

53. Governments were asked to subscribe on a voluntary basis if they thought it appropriate to the high standard, the "special data dissemination standard" (SDDS). The new standard is to improve the coverage, timeliness, availability, integrity and quality of data provided to the public. The standard specifies the data to be reported and includes coverage of the real and financial sectors, external trade and finance and fiscal indicators. Information about data release dates, methodology, authorities with advance access to data and proxies for assessing the quality of data are also to be provided. The Fund agreed to establish an electronic bulletin board by the end of August 1996, on which it would list the participants in the SDDS, although data provision itself would be the responsibility of individual Governments.

54. The data initiative is likely to be important in the long run, as more information (and more reliable information) enhances the confidence of international investors in developing and transition economies. In the short

run, however, the participation of many lower-income developing countries and transition economies will be limited by their relatively weak statistical systems. The Fund has planned to provide technical assistance to countries that wish to develop their statistical capabilities. But IMF does not itself intend to try to enforce the standards of reporting, which will be the responsibility of the Governments themselves.

55. The United Nations, through its methodological work and technical assistance, complements this IMF effort to improve the data that is collected and made available to the public and financial markets. At the technical level, the United Nations - together with the Commission of the European Communities, IMF, OECD and the World Bank - has revised the System of National Accounts, which now provides a more comprehensive as well as consistent framework for economic and financial analysis. In addition, because more than narrow economic and financial indicators are needed to assess the situation in any given country, the Statistical Commission is already considering a proposal to establish a minimum national social data set, with which to monitor social dimensions of development and social consequences of economic developments.

56. These data initiatives may also serve to bolster the market and electoral discipline of policy makers, as the commitment to more openness leaves a Government exposed to the threat of market or voter reaction to negative data. This might serve as an additional prod to Governments to take earlier actions in response to unsustainable policy mixes.

57. A caveat is warranted here, however, regarding the expected positive role of market discipline: markets are not necessarily perceptive disciplinarians. In other words, any market action taken in response to more timely data still depends on investor judgement regarding risk and reward. Looking back at the Mexican crisis, it could be argued that many investors remained complacent in the face of deteriorating economic conditions that were observable in data that were available, even if data on holdings of official reserves were lacking after a point in time. Information is only one factor in international financial decision-making and the lack of information should not be made the scapegoat for inopportune decisions by investors.

2. Emergency programmes and supplementary financing

58. Besides the effort to encourage more cautious macroeconomic behaviour on the part of capital-importing countries and provide more information to market lenders, the international community took additional steps in acknowledgement of a very significant characteristic of the global financial system: it is vulnerable to sharp swings in sentiment that can bring about extremely disruptive changes in financial flows. Moreover, as was seen in the aftermath of the Mexican crisis, a "contagion effect" can disrupt other countries.

59. IMF thus sought to prepare for the possibility of future crises of confidence in the financial markets. There were two steps: establishing a mechanism for rapid decision-making on deploying IMF resources in an emergency and ensuring that IMF would have access to an unusually large volume of financial resources should the need arise.

60. The first step was embodied in an "emergency financing mechanism", which the Interim Committee endorsed in September 1995. Eligibility for emergency financing would be limited to countries with sound economic policy fundamentals, but whose financial condition was being undermined by the behaviour of financial investors. Determining when a country might qualify need not be simple, however, given normal lags in data provision and other informational limitations, especially in the light of the relatively short time span in which decisions were to be taken. The Fund thus decided that a country's "track record" of effective dialogue with Fund staff and implementation of policy advice would be important in pre-qualifying for emergency financing. In effect, the emergency financing mechanism would operate as an extension of enhanced surveillance.

61. The Fund also had to consider whether the new mechanism was aimed primarily at easing concerns about systemic failure in the international financial system, or as support to economies that might be rocked by the behaviour of international financial markets. The Executive Board agreed that eligibility would not be limited to large countries.

62. Beyond eligibility issues, the effectiveness of the programme would depend on how the funds would be provided. Eligible countries would need to have virtually instantaneous access to funds. New procedures for drawing funds under the emergency mechanism were thus required, such as a pre-approved line of credit that the Executive Board could invoke at short notice and that would streamline the Fund's normal disbursement procedures. To obtain such an advance approval virtually entails an obligation of more regular reporting of economic performance data to the Fund.

63. The second step in the new programme was to ensure that IMF would have sufficient resources at hand to disburse quickly. Potentially large drawings of funds might be needed to stabilize the financial market, especially in the case of large countries carrying some systemic risk for the international financial system. Even if the Fund's own liquidity at a moment was sufficient to support an extraordinary drawing, the disbursement would reduce the amount of funds available for other programmes and countries. Thus, the Fund sought to bolster its own access to outside sources of credit.

64. The Fund has used borrowed resources for various lending programmes over the years. The first and largest arrangement was the General Arrangements to Borrow. It was set up to deal with emergency financing needs involving the major developed economies. As established in 1962, the Governments of the Group of 10 agreed to lend funds to IMF to lend to other members of the Group, should the need arise for extraordinary drawings. Later, Saudi Arabia became associated with the General Arrangements to Borrow as a lender and it was agreed that Arrangements resources could be used for non-members. The proposed new credit line that would be made available to IMF would be in the form of a further expansion of the General Arrangements to Borrow.

65. The Group of 10 and other countries with the capacity to provide financial contributions began meeting to arrange to double the General Agreements to Borrow to $50 billion and make it the "first and principal recourse" should the need arise to provide additional resources to IMF. After a review of the

current Arrangements by the Executive Board of IMF and meetings between the prospective participants, agreement was reached in the spring of 1996 on the broad principles of the new Arrangements and indications of countries' willingness to participate were received. Full agreement was expected by the time of the annual IMF and World Bank meetings in October 1996.

66. The international community has thus demonstrated anew its capacity to act quickly and innovatively in the face of newly perceived dangers in the globalized financial system. Questions were being raised, however, about whether the new Arrangements would work to reduce instability or have the reverse effect and raise it. The argument about the latter concerns "moral hazard", which is the belief that risks that would otherwise be avoided can be taken because there are rescue mechanisms.

67. The Fund anticipated this possibility in requiring a high degree of surveillance and cooperation for a country to be eligible to use the emergency financing mechanism. Moreover, as the Mexican case demonstrated, even with a rescue package of some $50 billion, a very difficult economic adjustment process was required. This is not the kind of development that political authorities would risk undergoing lightly. Thus, moral hazard with regard to government policy is not seen as a major risk.

68. More problematic is the moral hazard regarding private investor behaviour, which could become even more speculative than it often is if investors believe that Governments will be saved from default. This possibility was also recognized in an explicit warning to the financial community that "there should be no presumption that any type of debt to the private sector will be exempt from payments suspensions or restructuring in any future sovereign liquidity crisis". 25/ Moral hazard risk may thus be discouraged, albeit as much by the fact that the new General Arrangements to Borrow will be "only" $50 billion, the amount committed to Mexico alone, as by the explicit warning by the Group of 10.

V. CONCLUSION

69. In its resolution 50/91, the General Assembly stressed that global financial integration should constitute a very important element of the dialogue between the United Nations system and the Bretton Woods institutions. At the intergovernmental level, a forum for this exchange is provided by the policy dialogue with the heads of the multilateral trade and financial institutions that forms part of the high-level segment of the annual sessions of the Economic and Social Council. The General Assembly may wish to consider whether and how, in the light of its interest in the subject, global financial integration might be specifically addressed during the Council's policy dialogue.

70. At the secretariat level, both the United Nations and the Bretton Woods institutions produce a variety of reports for their respective intergovernmental bodies. Each of these reports responds to the perceived needs of those bodies and is the responsibility of the secretariat concerned. Nevertheless, informal consultations and exchanges of information among the secretariats sometimes take place in the preparation of the reports, with their intensity depending on the subject matter. To facilitate discussions at the intergovernmental level, such

exchanges could be enhanced and their outcome brought to the attention of the General Assembly, particularly on issues where the secretariats have different perspectives.

Notes

1/ Recent developments in this area are reviewed in the report of the Secretary-General on net transfer of resources between developing and developed countries (A/51/291).

2/ See "Limitations of macro-policy in industrialized countries", World Economic and Social Survey, 1995 (United Nations publication, Sales No. E.95.II.C.1), chap. IV.

3/ The countries comprise Canada, France, Germany, Italy, Japan, United Kingdom of Great Britain and Northern Ireland and United States of America.

4/ See C. Fred Bergsten and C. Randall Henning, Global Economic Leadership and the Group of Seven (Washington, D.C., Institute for International Economics, 1996).

5/ This account is based on Lawrence Summers, "U.S. policy toward the international monetary system on the eve of the Lyon Summit", statement made at the Emerging Markets Traders Association, New York, 25 June 1996.

6/ The Group actually comprises 11 countries: Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, United Kingdom and United States.

7/ See Manuel Guitián, The Unique Nature of the Responsibilities of the International Monetary Fund, Pamphlet series, No. 46 (Washington, D.C., IMF, 1992).

8/ See "Finance Ministers' report to the Heads of State and Government on international monetary stability", G-7 Summit, Lyon, 28 June 1996.

9/ IMF, Annual Report, 1995 (Washington, D.C., 1995), p. 46.

10/ The IMF Board has also asked to be informed when the IMF staff discern cases of "exchange rate misalignments that might pose an important systemic risk" (ibid.).

11/ For an enumeration of international mechanisms, see International Capital Markets: Developments, Prospects and Policy Issues (Washington, D.C., IMF, 1995), pp. 158-161.

12/ For a review of one year's activities, see Bank for International Settlements, 66th Annual Report (Basel, Switzerland, 10 June 1996), pp. 171-176.

13/ In addition, this is a matter monitored by the central banks of the Group of 10, through their Committee on Payment and Settlement Systems.

14/ A draft of part of this section was provided by the UNCTAD secretariat.

15/ Membership includes the 11 countries in the Group of 10 and Luxembourg.

16/ For an introduction to derivatives markets and issues in their regulation, see UNCTAD, Trade and Development Report, 1995 (United Nations publication, Sales No. E.95.II.D.16), pp. 99-115.

17/ See International Capital Markets ..., p. 141.

18/ Group of 10, The Resolution of Sovereign Liquidity Crises (Basel, Switzerland, Bank for International Settlements, May 1996), p. 34.

19/ The following draws heavily on the case studies of investment in developing and transition economies and countries emerging from conflict situations in World Economic and Social Survey, 1996 (United Nations publication, Sales No. E.96.II.C.1), chaps. VI, VII and VIII.

20/ For example, when liberalization of import tariffs deprives a Government of a major source of tax revenue, another tax source needs to be invoked to avoid a fiscal problem.

21/ For the background papers to the Board's discussion, see Peter J. Quirk, Owen Evans and a staff team, Capital Account Convertibility: Review of Experience and Implications for IMF Policies, Occasional paper No. 131 (Washington, D.C., October 1995).

22/ See Ricardo Ffrench-Davis and Stephany Griffith-Jones, eds., Coping With Capital Surges: the Return of Finance to Latin America (Boulder, Colorado and London, Lynne Rienner Publishers, Inc., 1995), pp. 225-260; Vittorio Corbo and Leonardo Hernández, "Macroeconomic adjustment to capital inflows: lessons from recent Latin American and East Asian experience", The World Bank Research Observer, vol. 11, No. 1 (February 1996), pp. 61-85; and Eduardo Fernández-Arias and Peter Montiel, "The surge in capital inflows to developing countries: an analytical overview", The World Bank Economic Review, vol. 10, No. 1 (1996), pp. 51-77.

23/ For a review of World Bank activities in this regard, see Annual Report, 1995 (Washington, D.C., World Bank, 1995), pp. 29-35.

24/ These included six members of the G-7 (IMF Survey, 23 October 1995, p. 318).

25/ Communiqué of the meeting of Finance Ministers and Central Bank Governors of the Group of 10 countries, 22 April 1996, para. 3.